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RUCPDO/DEPT OF COMMERCE WASHINGTON DC
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RUEHKO/AMEMBASSY TOKYO 2095
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TREASURY FOR IA-SETH SEARLS AND JWEEKS
SINGAPORE FOR SBAKER
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DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR TCURRAN
DEPARTMENT PASS EXIM BANK
USDA/FAS/OA YOST, MILLER, JACKSON
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SUBJECT: CENTRAL BANK TENTATIVE AS INFLATION EXPECTATIONS BUILD

REF: Jakarta 1082

1. (SBU) Bank Indonesia (BI) raised its reference rate by 25 basis points on June 5, signifying a cautious approach to fighting inflation in order to maintain economic growth momentum. Most analysts expected a larger rate hike, given mounting price pressures. Global food and fuel prices are set to remain high this year, providing both challenges and opportunities for Indonesia, according to a World Bank Forum on high international commodity prices. The ability of the Government of Indonesia (GOI) to capitalize on opportunities remains uncertain, according to the experts. End Summary.

Central Bank Cautious

2. (SBU) On May 5, BI raised the reference interest rate 25 basis points for the second time this year in response to increased inflation in May. The central bank also moved its reference rate from the 30-day SBI rate to the overnight inter-bank rate as of June 9 to reduce volatility in the overnight market. Most market analysts had expected a larger rate hike, given mounting price pressure (reftel). In the accompanying press statement, BI officials attributed much of the rise in May inflation to external sources. BI Governor Boediono also noted to the press that the central bank will use all monetary tools available to control inflation, including managing exchange-rate volatility.

3. (SBU) According to a member of the parliament's (DPR) banking and finance committee (Commission 11), BI plans to raise rates to 9.5% by the end of the year in 25 basis point increments. The plan for slow and steady rate increases contrasts sharply with the central bank's response to inflation in 2005, when BI increased rates by a total of 425 basis points over a five month period. While the recent increase in subsidized fuel prices is considerably lower than the increase in 2005, non-fuel inflationary pressures are greater this year than in 2005. In addition, there are signs that inflationary expectations are growing. Local research firm Danarksa's index of inflation expectations rose to its highest level yet recorded in May, surpassing the level in November 2005.

14. (SBU) The GOI and the central bank will face a critical test in the coming months as they attempt to tackle inflation and maintain economic growth. A failure to control inflation is likely to result in a loss of confidence from market participants, particularly international investors. The GOI recently announced plans to raise \$1.5 billion in international markets to finance the budget deficit.

The ability of the GOI to secure international financing at a reasonable price will be an important gauge of market sentiment toward Indonesia. In addition, signs of slower consumption, the dominant driver of growth in Indonesia over the past 12 months, have emerged. Bank Indonesia's consumer confidence index fell to a two and a half year low in May, while Danareksa's May consumer confidence index fell to its lowest level since November 2005.

Panel Cites Commodity Price Challenges, Opportunities

15. (U) High global fuel and food prices are unlikely to abate in the short run according to experts at a World Bank-sponsored conference on the impact of high commodity prices in Indonesia. The panelist reported that higher food and fuel prices continue to disproportionately impact the poorest of the poor in Indonesia. The experts urged Indonesia to undertake targeted, conditional cash transfer programs to assist the poor and promote sustainable economic development, rather than the current unconditional cash transfer program or in-kind transfers. The group criticized the GOI's subsidized rice program (RASKIN), arguing that RASKIN is difficult to implement and produces leakages. They pointed out that most poor households can only afford to purchase 6 kg of rice per month, rendering the increase in the amount available to poor

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households to 15 kg meaningless.

16. (U) The forum speakers also noted that Indonesia stands to gain significantly from higher commodity prices, particularly in the agriculture sector. However, those gains depend on the GOI's ability to enable productivity gains in the sector. Restrictive land-use policies, limited access to new agriculture technology, and poor infrastructure inhibit productivity gains in agriculture. The lack of infrastructure in rural communities also exacerbates poverty rates by increasing prices in hard to reach locations. According to the experts, the rice price disparity between regions in Indonesia can be as high as 64 percent.

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